

## ATTACHMENT 1

## **DECLARATION OF CARL R. GEPPERT**

I, CARL R. GEPPERT, declare that:

I am a Certified Public Accountant and a partner of Arthur Andersen LLP. My business address is 1225 17<sup>th</sup> Street, Suite 3100, Denver, Colorado 80202. Andersen Worldwide, with over 100,000 people, provides professional services to clients through member firms in 361 locations in 76 countries. It consists of Arthur Andersen ("AA") for audit, tax, business advisory and specialty consulting services and Andersen Consulting for global management and technology consulting. I am a member of a group at AA that provides audit, tax and consulting services to clients in the communications industry.

During my 18-year career, I have been almost exclusively involved in financial, regulatory and cost accounting matters in the telecommunications and utilities industries. I have served as an auditor for and consultant to clients in the telecommunications industry and currently direct my firm's telecommunications industry practice in the areas of regulatory accounting, auditing and consulting. I am our Firm's representative on the Telecommunications Subcommittee of the Public Utilities Committee of the AICPA.

### **PURPOSE AND SCOPE OF DECLARATION**

This declaration will address certain aspects of the Federal Communications Commission ("FCC") Accounting Safeguards Division's ("ASD") December 22, 1998 Draft Report, Audit of the Continuing Property Records of U S WEST Telephone Operating Companies - As of June 30, 1997 (the "December Report"). Specifically, I will evaluate both the adequacy and completeness of the audit procedures performed by the ASD at U S WEST, Inc. ("USW") related to the physical verification of hardwired central office equipment ("COE") and the propriety of the ASD's recommendations based on the results of the above audit procedures. In summary, the following key points should be highlighted:

- Audit Procedures Related to Telecommunications Plant – no individual audit procedure, such as the CPR physical verification procedure performed by the ASD staff, is necessarily indicative of a material misstatement in the financial statements.
- Sufficiency of the ASD's Audit Procedures – the ASD's audit procedures were deficient in many respects and do not provide a reasonable basis for rendering an opinion as to the fair presentation, in all material respects, of USW's COE plant investment balance pursuant to generally accepted auditing standards ("GAAS").
- Impact of Audit Results on Regulated Rates for Telecommunications Service – under current price cap regulation, the ASD audit results should have no impact. Even under traditional rate of return regulation, the cumulative impact of these results would be minimal due to the use of mass asset accounting and remaining life depreciation.
- The Need for Simplification of the FCC's Property Record Requirements – the FCC should simplify its Rules and Regulations as they pertain to property records and expense limits.

## **AUDIT PROCEDURES RELATED TO TELECOMMUNICATIONS PLANT**

### **Generally Accepted Auditing Standards**

Audit procedures related to a specific account balance or class of transactions cannot be considered in isolation in forming a conclusion with respect to such account balance or group of transactions. This is because audit procedures performed related to other financial statement accounts might also provide evidence relative to the fair presentation of the account balance in question. For example, tests of the propriety of the balance in accounts payable may provide evidence with respect to the proper recording of both telecommunications plant and expense transactions. Such tests provide audit evidence with respect to both the debits and credits recorded in the company's general ledger.

Under GAAS, audit procedures and the results of such procedures should be considered in light of both audit risk and materiality.<sup>1</sup> The auditor should design the audit plan "to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion."<sup>2</sup> "Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor."<sup>3</sup> Audit results should take into account the results of various procedures performed and evidential matter gathered. No individual audit procedure is necessarily indicative of a material misstatement in an account balance or class of transactions - other corroborating evidence must be obtained. Without such evidence, it would be inappropriate for the auditor to conclude with respect to the fair presentation of an account balance such as telecommunications plant.

### **Example Telecommunications Plant Audit Procedures**

Audit testing in the telecommunications plant area should consider tests of both the system of internal controls related to telecommunications plant (compliance testing) as well as the plant account balances (substantive testing). It should be noted that while telecommunications plant is significant to the Company's balance sheet, its significance in the rate-setting process has diminished significantly due to the adoption of price cap regulation and the use of mass asset accounting and remaining life depreciation methods.

In addition to controls over the maintenance of property records, internal controls related to the following areas should be considered in the telecommunications plant area:

- Telecommunications plant additions, retirements and adjustments
- Telecommunications plant job estimate/work order process

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<sup>1</sup> AICPA, Statements on Auditing Standards, AU Section 312: Audit Risk and Materiality in Conducting an Audit.

<sup>2</sup> AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Sufficiency of Evidential Matter."

<sup>3</sup> AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Nature of Evidential Matter."

- Transfers of plant assets from plant under-construction to plant in-service
- Physical safeguards over telecommunications plant assets
- Periodic physical inventories of plant assets and resultant processing of plant verification adjustments (both over- and understatements)
- Capital versus expense classifications of costs
- Capitalization of salaries, benefits and other overhead costs to telecommunications plant accounts (and related testing of employee time reporting to capital accounts)
- Capitalization of interest
- Capital budgeting controls and investigation of budget versus actual variances
- Process for evaluating the net realizable value (potential impairment) of plant assets
- Cash disbursements
- Depreciation
- Reconciliations of underlying supporting documentation and records to the accounting records (general ledger)
- Testing of the electronic data processing controls over specific application systems through which significant plant transactions are processed

Note that the above neither represents an all-inclusive list of procedures to be considered nor would each area be considered during every audit. The degree of testing should always be determined based on the auditor's judgment.

Substantive testing of telecommunications plant transactions in the above areas and of the year-end balances in various plant accounts may also be performed. Tests of physical verification of plant assets would often be performed during the substantive testing phase of the audit of telecommunications plant. The above tests would routinely involve both sampling applications (such as the procedures performed by the Accounting Safeguards Division) and nonsampling audit procedures. The results of all relevant procedures should be considered collectively in forming a conclusion with respect to an account balance or class of transactions.

### **Internal Controls - Cost/Benefit Considerations**

As noted above, the results of any individual audit procedure should not be considered in isolation when forming an opinion on an account balance or class of transactions. Various audit tests will uncover errors in recordkeeping and/or the accounting records – in many cases, these errors may be detected and corrected by other internal control procedures. Simply stated, any system of internal controls is not without limitations. "Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's control objectives. Another limiting factor is that the cost of an entity's internal control should not exceed the benefits that are expected to be derived."<sup>4</sup>

In the telecommunications plant area, given the magnitude of the plant balances and the significant number of transactions processed throughout the year, it is not unreasonable to assume that certain errors may occur and not be detected by the

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<sup>4</sup> AICPA, Statements on Auditing Standards, AU Section 319: Internal Control in a Financial Statement Audit, "Limitations of an Entity's Internal Control."

Company's system of internal controls. In fact, it is our understanding that plant verification procedures performed by the Company over time have routinely uncovered both over- and understatements of plant assets. Adjustments for such differences have been recorded, as appropriate, in the Company's accounting records. This plant verification process has served as an effective control procedure, not as an immediate indicator of large-scale misstatements of the plant accounting records.

### **Evaluation and Communication of Audit Results**

In accordance with GAAS, auditors are required to discuss certain audit findings with management and the Audit Committee of the Board of Directors. Many government agencies, including the U.S. General Accounting Office ("GAO"), follow generally accepted government auditing standards ("GAGAS") in conducting their audits. These rules, codified in Government Auditing Standards,<sup>5</sup> specify that "auditors should report the views of responsible officials...concerning auditors' findings, conclusions and recommendations."<sup>6</sup> These rules go on to state that, "One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials and others, as may be appropriate. Including the views of responsible officials produces a report that shows not only what was found and what the auditors think about it but also what the responsible persons think about it and what they plan to do about it."<sup>7</sup> In addition, these rules require the auditor to evaluate management's comments on the audit findings and *modify the findings if necessary*. "When the comments oppose the report's findings, conclusions or recommendations, and are not, in the auditors' opinion, valid, the auditors may choose to state their reasons for rejecting them. Conversely, the auditors should modify their report if they find the comments valid."<sup>8</sup>

To perform an effective audit, preliminary audit results should be discussed with management in order to ensure that the auditor has obtained the best evidence possible and reached the appropriate conclusions. AA's firmwide auditing policies require the audit team to discuss preliminary findings with management and, if management presents evidence that contradicts the audit findings and can be verified, the audit team should modify the results to reflect the newly received evidence.

GAAS require that, when an auditor becomes aware of information subsequent to the issuance of the audit report that would have prompted the auditor to investigate the information had it been known, the auditor must determine whether the information is reliable and whether the facts existed at the date of the audit report.<sup>9</sup> If the evidence is found to be reliable and to have existed at the date of the audit report, the auditor must determine 1) if the audit report would have been affected had the information been known and 2) whether it is likely that users or likely users of the report would attach importance to the new information. If the auditor has concluded that items 1) and 2) in

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<sup>5</sup> Government Auditing Standards: 1994 Revision, issued by the United States General Accounting Office, Comptroller General of the United States (June 1994) [hereinafter Yellow Book].

<sup>6</sup> Yellow Book, ¶ 7.38

<sup>7</sup> Yellow Book, ¶ 7.39.

<sup>8</sup> Yellow Book, ¶ 7.42

<sup>9</sup> AICPA, Statements on Auditing Standards, AU Section 561: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

the preceding sentence do apply, appropriate disclosures of the newly discovered facts should be made to the users or likely users of the audit report.<sup>10</sup> If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report.<sup>11</sup>

## EVALUATION OF ASD PHYSICAL VERIFICATION AUDIT PROCEDURES

Physical verification audit procedures often serve as an effective substantive test of the fair presentation of telecommunications plant account balances. As discussed above, the results of such procedures should be considered in conjunction with other audit evidence in forming a conclusion with respect to the fair presentation of plant account balances and related transaction activity. Physical plant verification procedures must be executed carefully, however, due to the high volume of plant transactions processed in the accounting records at a company the size of USW.

In performing its physical verification procedures, the ASD staff stated that its objectives were: "to determine the extent to which USW's continuing property records ("CPR") reflect the assets it uses in the provision of telecommunications services; to substantiate the investment recorded in USW's plant accounts; and, in general, to determine the extent to which USW is in compliance with the Commission's property record requirements."<sup>12</sup> The ASD's audit involved selecting 33 central offices and reviewing 36 items per office, resulting in a total of 1,188 items to be physically verified.<sup>13</sup> The ASD fell short of achieving its objectives in several respects, as discussed below.

- No adjustment for timing differences -- The ASD staff utilized USW's CPRs related to COE as of June 30, 1997 as the population from which the sample items to be verified would be selected. The physical verification of such equipment items did not occur, however, until August and September 1997. There were no procedures performed, normally termed "cutoff procedures," to account for any plant additions, retirements, adjustments, etc. that may have occurred during the time period from June 30, 1997 to the date of the physical verification. Thus, to the extent that the ASD staff could not find equipment at the central office location during its physical verification, it is certainly possible that such plant could have been retired subsequent to June 30, 1997 but prior to August or September 1997. Classification of such items as "not found" would be clearly inappropriate in this instance.
- Failure to verify USW's supplemental evidence -- Prior to release of the ASD's December Report, the ASD released to USW a draft of the report on July 20, 1998 (the "July Report"). USW was given an opportunity to respond to the ASD's findings before the ASD finalized its report. As part of USW's response, USW supplied the ASD with supplemental information that indicated 78% of the items classified as "not found" or "unverifiable" by the ASD's physical verification team were inappropriately classified as such. The evidence submitted by USW indicated that

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<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> FCC Draft Audit Report, "Audit of the Continuing Property Records of USW As of June 30, 1997," issued July 20, 1998 (hereinafter referred to as the "July Report").

<sup>13</sup> Ibid.

ASD's results were inaccurate for reasons including the following: 1) assets had been physically located by USW, 2) assets were determined to have been physically removed (but the retirement had not been reflected on the CPR) and 3) assets had been inappropriately reflected on the hardwired COE CPR, when in fact the assets were plug-in COE. In the instances that USW found the CPR to be incorrect, adjustments were made to the CPR.

AA reviewed the supporting documentation related to the verification efforts performed by USW. In addition, AA selected one of the central offices included in the ASD's sample to perform physical verification procedures to corroborate USW's verification efforts as discussed above. AA was able to physically identify certain assets noted as "found" in USW's response. The evidence submitted by USW suggests that the ASD should have taken additional steps to verify the information and update the audit findings.

The December Report has identical findings to those in the July Report, thus indicating that no consideration was given to the supplemental evidence provided by USW. In addition, per discussion with USW personnel, the ASD did not perform any follow-up procedures to verify the evidence provided by USW.

- No consideration for understatement – The ASD's physical verification procedures were solely directed at detecting instances of potential overstatement in the plant accounting records. Instances of potential understatement were not considered. In other words, the ASD's physical testing procedures would only reveal instances where COE items included on the June 30, 1997 CPRs were not in the specified location as detailed in such CPRs. A comprehensive test of the physical existence of plant assets would not only consider instances of potential overstatement, but would include procedures such as the selection of assets in the respective central offices and the tracing of such assets to the CPRs to ensure that the CPRs are not understated. Only by testing for both potential over- and understatements can one begin to form the basis for concluding as to the propriety of the telecommunications plant account balances.
- Restrictive field audit procedures – In addition to the above flaws in the physical verification test design, the field audit procedures followed appear to have been restrictive. Per discussions with USW personnel, the ASD auditors were on-site in each location for a period of one day - there were no subsequent follow-up visits to any of the 33 central office locations. Thus, Company personnel were only given a limited amount of time to locate the sampled COE items that the ASD staff was attempting to physically verify. This limited window of time seems inadequate, particularly considering the fact that certain items of COE tend to be small and "built-in" to other assets, thus making these assets difficult to find. To the extent that sampled items were physically located after the fact, Company personnel stated that the ASD staff was generally unwilling to consider such findings in their results. This process does not seem reasonable. In addition, there appeared to be little communication of audit issues, evaluation standards or preliminary audit results throughout the ASD's audit process. Normally, Company personnel would be given adequate time to respond to any preliminary audit issues and findings, and alternative procedures such as return visits to central office sites in addition to

review of other supporting documentation would be performed in order to derive complete and accurate audit results.

- **Failure to review accounting records** – Finally, it should be noted that the ASD audit concentrated only on the CPRs and not the COE plant account general ledger balances. It seems unreasonable to conclude that the Company's hardwired COE investment is overstated when the accounting records evidencing such investment were not reviewed. To the extent that adjustments had been made to the accounting records and not to the supporting CPR detail, for instance, the audit would not have detected such adjustments which obviously would impact any conclusion with respect to the fair presentation of the accounting records.

As in the above section, the discussion of the sufficiency of the ASD's audit procedures is not meant to be all-inclusive. As we did not have access to the ASD's audit program or the related audit workpapers, a complete evaluation of the sufficiency of procedures performed could not be performed.

## **ASSESSMENT OF ASD AUDIT FINDINGS AND RECOMMENDATIONS**

The December Report included the following recommendations:

1. USW should write-off \$378.6 million of hardwired COE plus an additional \$218.6 million of "Undetailed Investment," assets which are on the CPR but do not have specific descriptions or locations.
2. USW should engage an independent auditor to evaluate the practices, procedures and controls USW has in place to maintain its CPR and recommend improvements.
3. USW should engage an independent firm to conduct a complete inventory of its CPR for its COE and report the results to the ASD for determination of additional accounting adjustments, if necessary.<sup>14</sup>

The ASD's recommendation that USW write-off \$378.6 million of hardwired COE is fundamentally flawed. This write-off amount was determined by extrapolating the results of the ASD's sample physical verification procedures to the entire hardwired COE population. Since USW has submitted evidence that the ASD's findings are inaccurate, the extrapolated amount is too high. In addition, the extrapolation calculation is based only on CPR items that were (in the ASD's opinion) overstated, and no consideration was given to understatements, which would impact (reduce) the extrapolation. Further, the ASD's statistical approach does not lend itself to such an extrapolation, as further discussed in a separate response submitted to the ASD by USW.

The ASD's recommendation that USW write-off \$218.6 million of Undetailed Investment is also inappropriate. Subsequent to the ASD's audit, USW has taken steps to properly identify the specific assets to which these dollars relate, thus reducing the Undetailed Investment to approximately \$1.7 million. The ASD should perform additional audit steps to verify USW's Undetailed Investment balance and modify the audit results accordingly.

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<sup>14</sup> Ibid.



It would be premature to require an adjustment prior to the performance of additional audit procedures, as discussed above. Recording the write-off currently as recommended by the ASD could quite probably result in a subsequent write-up upon completion of these additional audit procedures. This is particularly true given that the ASD's sampling procedures only looked for overstatements in the COE CPRs. In addition, the ASD's adjustment would be based on the CPRs at one point in time while the additional procedures would relate to a future, or multiple future, points in time. This timing difference would unduly complicate the recognition of any adjustment resulting from the additional procedures.

In conclusion, the recognition of a write-off based on the results of the ASD's COE CPR audit cannot be justified. In addition, AA issues opinions on the fair presentation of the U S WEST Communications, Inc. ARMIS Report 43-03. If USW were required to recognize a write-off that is not justifiable, the impacts on this cost allocation audit opinion, and the conclusions reached therein, would need to be considered.

To the extent that further audit testing should be performed, the ASD's recommendation of engaging an independent auditor to evaluate USW's procedures and controls is valid. In fact, this review should probably have been the first step performed in the audit process as discussed above. Such a review would produce corroborating evidence to support critical business processes utilized in the COE plant accounting and recordkeeping area. This effort would not only provide an objective assessment of the current internal control system related to COE but would also identify opportunities for USW to enhance its current processes and enable USW to more accurately maintain its hardwired COE CPR.

Further substantive audit procedures, such as the performance of a complete physical verification of all COE as recommended by the ASD, should not be performed until the procedures and controls review discussed above is completed. Upon completion of this review, the auditor would assess the residual audit risk associated with COE and design further audit tests, if necessary, to verify the accuracy of the COE plant investment balance. Should further physical verification be necessary, alternative procedures such as verification of high dollar value items only, or rotational physical inventories of COE over an extended period of time, where the entire COE asset base would be verified every 5 years, for example, would be more practical and cost-beneficial.

## **IMPACT OF AUDIT RESULTS ON REGULATED RATES FOR TELECOMMUNICATIONS SERVICE**

As noted above, the results of the ASD's audit sampling procedures should not be considered in isolation in determining the degree of over/understatement of the Company's COE plant balances. In fact, as the audit procedures were directed solely to the Company's property records and not to the accounting records (financial statements), it would be difficult to evaluate whether the accounting records were fairly stated. Furthermore, the objective of maintaining property records is to document the cost of assets used in providing services to customers. If an asset is in-service but in a different location within a central office than that listed on the property records, for example, the asset is fairly stated and the objective satisfied.

If one were to assume such audit results were accurate, however, their impact on regulated rates would be minimal due to the following:

- **Use of Mass Asset Accounting**--one of the primary reasons cited by the Company in instances where specific sampled plant assets could not be located within the central office is that such plant had inadvertently not been retired from the property records. Pursuant to the Part 32 Rules and Regulations, plant such as COE is accounted for using mass asset accounting. As provided for in Section 32.2000, the accounting for the retirement of COE assets involves crediting the appropriate plant asset account for the original cost of the asset and charging Account 3100, "Accumulated Depreciation," whether or not such plant had been replaced.<sup>15</sup> Thus, any subsequent retirement of assets would not impact net plant or net income.
- **Use of Remaining Life Depreciation**--the conclusion that a delay in plant retirements has caused an overstatement of depreciation expense related to such assets over time is also erroneous. The depreciation methodology used by the Company for regulatory purposes related to COE is remaining life depreciation, applied on a composite group (plant account) basis. Remaining life depreciation takes into account changes in both the asset mix and the depreciable lives of such assets as they occur, thus ensuring that plant assets are fully depreciated at the end of their depreciable lives. Remaining life depreciation rates are assessed annually based on mortality studies and plant retirement data which measure the remaining lives of currently held assets in each plant account. Depreciation rates may then be reset to reflect, based on current mortality/retirements data, the average remaining lives of assets currently recorded as in-service per the accounting records.

If retirements of COE had been delayed or never processed over time, such data would have been factored into the subsequent mortality/retirements analysis and into the resultant remaining life depreciation rate. In other words, unrecorded/delayed retirements would impact current and subsequent depreciation rates so that the resultant impact on revenue requirements would be zero over time. These impacts would be accompanied by temporary overstatement in the plant balances (rate base).

The above discussion is only relevant under traditional rate of return regulation (and less so under price cap regulation with earnings sharing). In any event, the impact of unrecorded/delayed retirements is not relevant under the FCC's current price cap regulatory regime (price cap regulation with no earnings sharing) as prices charged for regulated services are regulated, not the costs incurred to provide such services.

## **SIMPLIFICATION OF FCC RULES AND REGULATIONS**

The FCC is required by the Telecommunications Act of 1996 ("1996 Act") to review its accounting regulations every other year, beginning in 1998. The 1996 Act intended this requirement to eliminate rules that are no longer useful in regulating the telecommunications industry.

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<sup>15</sup> 47 CFR §32.2000(d)(2)(I).

In July and November 1998, AA, in association with several large local exchange carriers, filed with the FCC two reports on which illustrated numerous opportunities for the FCC to eliminate or modify regulations which are no longer serving a useful purpose.<sup>16</sup> Several opportunities identified by AA pertained to regulations governing property accounting, including maintaining overly detailed CPRs, as well as the unduly cumbersome requirement to track all costs regardless of their amount. AA further recommended that the FCC reduce the level of detail currently required to be maintained in the CPR, such as detailed plant subaccount, record category and bay/shelf/rack location. Finally, the FCC should allow USW and other telecommunications providers subject to the Part 32 Rules and Regulations to define and track property units at a level necessary to manage the business, nothing more.

AA further recommended that the FCC allow an expense limit on COE and other telecommunications plant, just as it allows for certain general purpose equipment. The current requirement that USW and other local exchange carriers track all COE, regardless of cost, is excessively costly and unnecessary. As discussed above, the ASD selected 1,188 items for its audit. Of the 1,188 items, 449 items (38%) (excluding the 14 items that had an in-place cost of zero) had a cost below \$2,000 per item. The total value of the 449 items, however, was only 3% of the total dollar value of the 1,188 items. Furthermore, 9 items had a cost below ten dollars. An even greater percentage of property units included in the ASD's sample had an individual unit cost below \$2,000. The fact that USW must capitalize, depreciate and maintain records for these de minimis items is unreasonable. The cost incurred by USW to maintain CPRs for these items clearly outweighs any conceivable benefit derived from maintaining CPRs for these assets.

## CONCLUSION

In summary, the ASD's limited physical verification audit procedures were not sufficient to form an opinion, in accordance with GAAS, as to the fair presentation of the Company's hardwired COE plant investment. Additional quality control procedures over the physical verification tests that were performed as well as additional compliance and/or substantive audit procedures would be necessary to render such an opinion pursuant to GAAS.

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<sup>16</sup> "Accounting Simplification in the Telecommunications Industry," Prepared by Arthur Andersen LLP, July 15, 1998, and "Supplement to July 15, 1998 Position Paper, Prepared by Arthur Andersen LLP, November 10, 1998.

This concludes my declaration.

Pursuant to 47 C.F.R. Section 1.16, I declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed this 9<sup>th</sup> day of January 1999.

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Carl R. Geppert

## **ATTACHMENT 2**



January 8, 1999

Mr. Mark A. Schumacher  
Executive Director – Accounting Operations  
US WEST, Inc.  
1801 California Street  
Denver, CO 80202

Dear Mr. Schumacher:

Deloitte & Touche LLP was asked by US West, Inc. to read and provide comments on the sampling methodology described in the draft FCC Accounting Safeguards Division (“ASD”) report, “Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings” (the “June ASD Report”). We provided US West with a letter containing our comments dated August 18, 1998. A copy of that letter is attached hereto.

You have now asked us to read the December 22, 1998 draft of the “Audit of Continuing Property Records of US West as of June 30, 1997; Report of Audit Findings” (the “December ASD Report”) and provide comments on the ASD’s response to our observations about the ASD’s sampling methodology that we made in our August 18, 1998 letter (which included several concerns that could affect the validity of the estimates).

Based on our reading, the December ASD Report does not address the observations in our August 18, 1998 letter which are most relevant to our summary stated in that letter, which is reiterated herein: *In summary, given the several questions and concerns about the sampling approach taken by the ASD, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.*

We have numbered the observations made in our August 18, 1998 letter (see attached letter) to facilitate the presentation of the basis for our conclusion that the December ASD Report does not address our August 18, 1998 observations which are most relevant to the summary presented above, as follows.

No.	D&T Observation on June ASD Report	ASD Response to D&T Observation	D&T Comment on December ASD Report
1	Criteria used to exclude over 500 offices from population was not explained.	No acknowledgement of observation or any response thereto.	We reiterate our August observation.
2	The process used to replace certain original sample selections was not documented.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
3	The rationale for using a high number of strata, with relatively few selections per strata was not documented.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
4	The explanation of sample design did not address the choice of the number of offices and the stratification of offices.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
5	Random selection based on units was used, rather than dollar-based sampling, which is more typically used when evaluating the value of accounting populations, especially populations in which the value of individual items varies widely.	No acknowledgement of observation or any response thereto.	We reiterate our August observation

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Mr. Mark A. Schumacher

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6	The precision range was very large, reducing the predictive value of the estimate of error in the population.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
7	There was not any reference to sampling guidelines for precision.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
8	Documentation was not provided for why mean-per-unit estimators were used, instead of ratio estimators (mean-per-unit estimators usually result in a larger precision range)	No acknowledgement of observation or any response thereto.	We reiterate our August observation
9	Sampling theory does not support the assertion that the actual cost of missing plant lies closer to the mid-point of the range.	Footnote 39 of the June ASD Report, which contained the assertion, has been removed.	The assertion continues to be made – see footnote 27 and pp. 12-13 of the December ASD Report. We again note that any individual sampling estimate within a precision range should be considered to be equally likely of being the actual amount of error.
10	Accounting standards do not support using the high end of a range, when all points in the range are equally likely of being the actual error.	Comment removed.	Response resolves our observation.



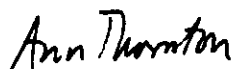
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11	Understatement errors were not considered as an offset to the findings that the population may be overstated.	No acknowledgement of observation or any response thereto.	We reiterate our August observation
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Additionally, we noted that the December ASD Report, in Appendix B, included additional results, which were said to be based on a Bayesian approach. However, we note that the discussion presented only results. It did not include formulas, calculations or other information that would be necessary for us to comment on the results presented. Given that there is not just one Bayesian approach, but rather a family of Bayesian approaches and analyses that can be executed in different ways, it is impossible to evaluate the Bayesian results presented in the December ASD Report.

Because the December ASD Report is not responsive to the observations made in our August 18, 1998 letter, we continue to have concerns that the sampling approach taken by the ASD may result in invalid sampling estimates. And, we reiterate that, even if the estimate is in fact valid, the size of the precision range, because it is large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,



Ann Thornton, Director  
National Director – Data Quality and Integrity Service Line



August 18, 1998

Ms. Kristine M. Ringsdorf  
Executive Director – Financial Accounting  
U S WEST, Inc.  
1801 California Street, Suite 2290  
Denver, CO 80202.

Dear Ms. Ringsdorf:

Deloitte & Touche LLP was asked by US WEST, Inc. to read and provide comments on the sampling methodology contained in the draft FCC report "Audit of the Continuing Property Records of US West As of June 30, 1997; Report of Audit Findings". I was asked to lead this project, since I am the Firm's designated quantitative techniques expert (statistical sampling, regression analysis, and other mathematical applications) and the National Director of the Data Quality and Integrity service line. As the Firm's expert, I consult on statistical applications for audit and tax purposes as well as for consulting engagements involving regulatory compliance. I have lectured at universities and CPA societies on statistical audit procedures, co-authored books on sampling and auditing, and was a member of the AICPA Subcommittee which drafted the Audit Sampling Guide to support Statement of Auditing Standards, No. 39, *Audit Sampling*.

The focus of a good sampling methodology should be to achieve a valid evaluation. To achieve a valid statistical result from a statistical sampling application, two critical steps must be appropriately performed:

1. In **sample selection**, the objective is to obtain a sample that is representative of the population from which it was selected. A representative selection might be unstratified (e.g., a simple random sample across an entire population) or stratified by some characteristic. Stratification involves dividing a population into subpopulations, based on a characteristic that is identifiable in each population item, selecting a separate sample of items from each subpopulation, and combining the results obtained from each subpopulation mathematically to achieve one combined statistical result.
2. In **sample evaluation**, the objective is to calculate an estimate and a range about that estimate (i.e., precision) at a specified confidence level using formulas supported by a

valid statistical methodology. The evaluation requires a representative sample selection and may only be extrapolated to the population from which the sample was selected.

In general, I do not believe that there is sufficient information in the Draft Audit Reports document to be able to determine whether or not the statistical estimates referred to in the Draft Audit Report are statistically valid. However I can make the following observations, included in which are several concerns, which could affect the validity of the estimates.

### Sample Selection

- ① • The definition of the population of the 1,131 offices subjected to sampling is not identified in the Draft Audit Report. The FCC report indicated that U S WEST provided information on over 1,700 offices. Out of this universe of offices, the FCC apparently only used 1131 offices for purposes of stratification and selection. There is no indication what criteria were used to exclude the 500 or more offices. Therefore, I cannot determine whether the population is appropriate for the audit objectives or whether the offices selected are likely to be representative of the population of offices.

② In addition, some initial selections were replaced with alternative selections, but the criteria used in determining what locations were deemed "impractical to audit" are not specified. If it is found necessary to replace randomly selected sample items, for whatever reason, doubts are immediately raised as to the statistical validity of the sampling plan. For this reason, it is customary to rigorously document the replacement process and also document that no bias has been introduced due to the replacement of sample items.

- ③ • I cannot assess whether the stratification used was appropriate, in part because of questions around the population definition (as discussed above). I am concerned about the effect of the small number of sample selections from certain strata on the validity of the evaluation. For example, as few as 2 offices were selected within a stratum of offices. Moreover, only 33 offices were selected out of a population of 1,131 offices. Typically, I would expect to see fewer strata with more selections per stratum. There is insufficient documentation in the Draft Audit Report to justify why so many strata with relatively small sample sizes within a strata might be expected to produce representative results.

④ The explanation of sample design on pages 3-5 of Appendix A addressed the appropriate size of "n", the number of items reviewed, but it did not address the choice of the number of offices and the stratification of offices. If an insufficient number of offices were reviewed in the multistage sampling approach, the resulting estimates could be biased or invalid. A biased or invalid estimate would not appropriately represent the true but unknown population value.

- ⑤ • Random selection was used to select line items in each selected office. Typically, when sampling from accounting populations, consideration is given to using dollar-based selection techniques, rather than simple random selections, to allow appropriate coverage

of higher dollar items. This is particularly relevant in tests of physical existence if high-dollar items are more likely to be located than small-dollar items, due to such factors as physical size and the extent of controls over more valuable assets.

### Sample Evaluation

- ⑥
- Statistical point estimates are only meaningful when they are combined with statements of confidence level and precision. In my judgment, the precision of \$197.4 million is very large in comparison to the estimate of \$378.6 million (52% of the estimate). The precision of \$197.4 million implies that the total dollar amount of error lies within the range \$181.2 million to \$576.0 million with a 95% level of confidence. I emphasize that the estimate of \$378.6 million is no more likely than any other point in the precision range from a statistical perspective. (This contradicts one of the assertions in footnote 39 on page 12 of the FCC report – see below.)

In this case, the total range of uncertainty is \$394.8 million (i.e.,  $2 \times \$197.4$  million), which is larger than the estimate of \$378.6 million. Typically, I would not expect that an estimate with such a wide precision range would be useful. I would expect that it would be necessary to do additional work, either to improve the precision or to support the use of a particular point within the range. In most instances, an estimate with such large precision would be of little predictive value without the support of independent corroborative information to assist in determining whether any point in the estimated range is reasonable.

⑦

Some U.S. government agencies have developed sampling guidelines for precision and confidence levels. Sampling guidelines help ensure that statistical methods are applied consistently and with reasonable parameters. For example, one Internal Revenue Service regulation indicates that the precision of an estimate should not exceed 10% of the estimate at a 95% confidence level. The Draft Audit Report does not reference any specific sampling guidelines for evaluation beyond the use of a 95% confidence level. In particular, there is no guidance as to the maximum size of acceptable precision ranges.

- ⑧
- A sample may be evaluated using different estimators, of which the most common are ratio and mean-per-unit estimators. The primary difference between the two is that a ratio estimator bases its estimate on the relationship between the total sample dollar error amount and the total sample dollar book amount, while a mean-per-unit estimator bases its estimate on the relationship between the total sample dollar error amount and the number of sample items. The FCC Draft Audit Report, in describing the formula for estimating the cost of hard-wired-COE not found, does not explain why mean-per-unit estimators were used, instead of ratio estimators. Mean-per-unit estimators, while not necessarily biased, usually result in less precise estimates (i.e., estimates with a larger precision range) than ratio estimators.

- 9 • I take exception to the conclusions in footnote 39 on page 12 of the Draft Audit Report. First, any amount within a precision range of an individual sampling estimate should be considered to be equally likely of being the actual amount of error. Sampling theory does not provide statistical support for the assertion by the FCC that, "It is more probable... that the actual cost of missing plant lies closer to the mid-point of the range." Second, while we acknowledge that conservatism is a general principle of accounting, when more specific accounting guidance exists, the specific guidance should be followed. In this case, Section C59 of the Financial Accounting Standards Board's *Current Text* sets forth the accounting for loss contingencies (loss contingencies are defined as existing when "it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements" [C59.105.a.]). The accounting requirement for loss contingencies, when no amount within a range is a better estimate of the loss than any other amount states "If no amount within the range is a better estimate than any other amount, however, the minimum amount of the range should be accrued." (C59.107).
- 10
- 11 • The tests described in the Draft Audit Report address potential overstatement of the population. When tests are performed for both overstatement and understatement, understatement errors are often used to partially offset overstatement errors and therefore reduce the size of the resulting overstatement estimate. US WEST has indicated that instances of understatement are present in the sample items reviewed by the FCC but are not included in the statistical evaluation. If this is true, the estimates presented may be higher than they should be, in that they do not allow understatement errors to reduce the estimated overstatement.

In summary, given the several questions and concerns about the sampling approach taken by the FCC, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is very large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.

Yours truly,



Ann Thorton, Partner

## ATTACHMENT 3

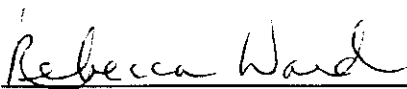
Undetailed Investment - 25 Item Inquiry

Item #	FRC	CPR	J. Drawing	YR	In-place Cost	ECN	Location	Remarks
1	57C	040000	UNDET INV	48	\$ 1,335.44		40 T63460	Retired 1-16-98 with transaction 04771705
2	57C	040000	UNDET INV	53	\$ 12,463.03		T63460	Retired 1-16-98 with transaction 04771708
3	57C	040000	UNDET INV	54	\$ 8,235.51		T63460	Retired 1-16-98 with transaction 04771709
4	57C	040000	UNDET INV	60	\$ 5,808.27		T63460	Retired 1-16-98 with transaction 04771713
5	57C	040000	UNDET INV	62	\$ 13,006.63		T63460	Retired 1-16-98 with transaction 04771715
6	57C	040000	UNDET INV	66	\$ 48,462.25		T63460	Retired 1-16-98 with transaction 04771718
7	57C	040000	UNDET INV	68	\$ 34,235.06	800	T63460	Retired 1-16-98 with transaction 04771720
8	57C	040000	UNDET INV	70	\$ 35,406.57	881	T63460	Retired 1-16-98 with transaction 04771722
9	57C	040000	UNDET INV	73	\$ 139,957.54	892	T63460	Retired 1-16-98 with transaction 04771725
10	67C	040000	UNDET INV	62	\$ 2,201.17	010M0	T63460	Retired 1-16-98 with transaction 04771727
11	67C	040000	UNDET INV	66	\$ 11.57	598	T63460	Retired 1-16-98 with transaction 04771730
12	67C	040000	UNDET INV	67	\$ 2,137.28	608E0	T63460	Retired 1-16-98 with transaction 04771731
13	77C	040000	UNDET INV	70	\$ 13.40	705EO	T63460	Retired 1-16-98 with transaction 04771735
14	77C	040000	UNDET INV	71	\$ 142.35	10711	T63460	Retired 1-16-98 with transaction 04771736
15	77C	040000	UNDET INV	72	\$ 257.77	C81027	T63460	Retired 1-16-98 with transaction 04771737
16	77C	040000	UNDET INV	73	\$ 3,914,823.35	701A0	T63460	Retired 1-14-98 with transaction 04768611
17	117C	040000	UNDET INV	55	\$ 600.00	607F0	T63460	Retired 1-16-98 with transaction 04771740
18	357C	040000	UNDET INV	90	\$ 8,268.90	050	T63460	Late billing mortality year adjusted to 1989 to match associated material spend. Monies were respread to the in-place cost
19	377C	040000	UNDET INV	59	\$ 1,925.30	701A1	T63460	Retired 1-16-98 with transaction 04771741
20	377C	040000	UNDET INV	89	\$ 100.00		T63460	Monies retired from the DCPR on 5-19-95
21	377C	040000	UNDET INV	89	\$ 14,331.21		T63460	Investment reclassified to 377C- under investigation as undetailed investment
22	377C	040000	UNDET INV	97	\$ 3,085.00		T63460	Late billing mortality year adjusted to 1996 to match associated material spend. Monies were respread to the in-place cost
23	457C	040000	UNDET INV	45	\$ 299.00		T63460	Retired 1-16-98 with transaction 04771743
24	457C	040000	UNDET INV	47	\$ 911.00		T63460	Retired 1-16-98 with transaction 04771745
25	457C	040000	UNDET INV	48	\$ 4,474.25		T63460	Retired 1-16-98 with transaction 04771746

## **CERTIFICATE OF SERVICE**

I, Rebecca Ward, do hereby certify that on this 11<sup>th</sup> day of January, 1999, I have caused a hard copy of **U S WEST, INC.'S RESPONSE TO DRAFT AUDIT FINDINGS - AUDIT OF CONTINUING PROPERTY RECORDS** (along with an electronic copy on diskette) to be submitted, via hand delivery, to the person listed below:

**Robert Hood  
Federal Communications Commission  
Accounting Safeguards Division  
Room 257  
2000 L Street, N.W.  
Washington, DC 20036**

  
\_\_\_\_\_  
Rebecca Ward